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Market Modernization and Median Democracy:

An Essay on Law and Economic Development

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Forum 1 Session on Political Economy

Market Modernization and Median Democracy:

An Essay on Law and Economic Development

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Abstract

This essay, which reports on the economic analysis of law and norms as it pertains to economic development, has two themes. First, effective business law aligns with business norms through an evolutionary process that I call "market modernization." Market modernization is decentralized and competitive. Modernization of law through politics ("political modernization"), which is centralized and noncompetitive, plays a smaller role. Second, stable politics in developing countries comes from median democracy, which occurs when the median voter determines political outcomes. A presidential executive, direct democracy (referenda and ballot initiatives), and factoring governments into special districts for the supply of local public goods (school boards, water districts, etc.) empowers the median voter. In contrast, a parliamentary executive (prime minister), indirect democracy (legislative rule), and splicing the supply of local public goods into comprehensive governments (e.g. the city council) creates bargain democracy, which is less stable.

Robert Cooter*

Market Modernization and Median Democracy: An Essay on Law and Economic Development

> Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and tolerable administration of justice; all the rest being brought about by the natural course of things. – Adam Smith.[1]

Adam Smith apparently thought that peace, easy taxes, and tolerable administration are sufficient conditions for economic develop. In reviewing economic changes in Russia since the collapse of communism, Gerard Roland describes another trinity. According to the "Washington Consensus View" that dominated at beginning of the transition, economic development in Russia requires privatization, liberalization, and stabilization. At his untimely death, Mancur Olson was working on a book with the theme that two conditions guarantee development in the modern world. First, individuals must have a broad set of secure rights, especially contract and property rights. Second, owners must not suffer predation by private individuals or the state.[2]

Underlying each of these theories, I believe, is the conviction that economic growth requires people to bet on ideas with their own money, and they will not bet much unless the odds are favorable. To make the odds favorable for many investors, the state must protect them from predation and expose them to competition. Factors that improve the odds form a long list that can be weighed statistically.[3] My subject is two of these factors: law and norms.

Douglas North asserts that "economic growth is dependent on stable political/economic institutions that will provide low costs of transacting in impersonal political and economic markets."[4] How do we get the necessary law and norms? They are not apparently "brought about by the "natural course of things," to quote Smith. The

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[1] Notebooks that formed the Wealth of Nations (Smith, 1755), as found in the Modern Library Edition of that book in the Editors Introduction, p. xliii. Thanks to Peter Boettke for bringing this remarkable quotation to my attention.

[2] (Olson, 2000). A summary of the manuscript and its theme was provided to me by Charles Cadwell.

[3] An early attempt to find the factors of growth econometrically is (Dennison, 1967). For recent reviews of the factors affecting growth in developing countries, see (Boettke, P. and J. R. Subrick, 2001), and (Azfar, O., 1999).

[4] (North, D., 1995).

model for the natural course of things is trade, which people do unless stopped. Making good laws and norms requires something more than not stopping people from following their inclinations. Indeed, much of law and morality tries to prevent people from following their inclinations. Envy over wealth and passion about rank are natural feelings. Suppressing envy and implementing workable conceptions of fairness require constraint by law and norms.

I will describe two ways to get two different kinds of laws. First, business law must align with business norms, and this alignment occurs more through an evolutionary process that I call "market modernization" and less through a political process. Market modernization is a product of the interaction between an independent judiciary and an intellectual community. Second, instability and corruption in developing countries results especially from insufficient democracy or the wrong kind of democracy. The developing nations suffer from a democracy deficit, by which I mean insufficient satisfaction of the demands of citizens for law and public goods. However, not any democratic institutions will do in developing countries. The preferred democratic forms must resist corruption and instability. In this respect, the forms of democracy that implement the median rule, which I call "median democracy," should be favored over the forms of democracy that implement bargaining. For example, direct democracy (within a system of constitutional rights) should be favored over indirect democracy.

I. Market and Political Modernization of Law[5]

In Europe the phrase "economic law" refers to laws that apply to the economy, notably the law of property, contracts, corporations, torts, and industrial regulation, as well as various specialized bodies of law such as commercial transactions, securities, bankruptcy, trusts, the environment, and labor relations. When economic law is poorly adapted to the economy, the results are conflicting expectations, problems with cooperation, and disputes over resources. Conversely, when economic law is adapted to the economy, people cooperate with each other, harmonize their expectations, and use resources efficiently and creatively. Modern economic law is adapted to the conditions

[5] This article draws upon two related papers: (Cooter, 1994), (Cooter, 1996).

of a modern economy where complex organizations apply science to the production of specialized goods and sell them in impersonal, competitive markets.

Many people believe that modernizing the law in developing countries requires comprehensive reform directed by politicians and state officials.[6] For example, business law must organize corporate governance,[7] labor law must restructure employment relations to protect workers,[8] land reform must reorganize agriculture and redistribute rural property,[9] antitrust law must suppress monopolies that obstruct development,[10] and safety regulation must protect consumers against defective products.[11] Priorities vary, but reformers agree that political leaders and state officials must take the initiative to replace outdated laws with comprehensive statutes.

An alternative approach to modernization takes common law as the model.[12] Economic competition changes products and techniques, which in turn creates new problems of coordination and cooperation. To solve these problems, communities develop norms that impose obligations and coordinate expectations. The state raises some of these social norms to the level of law. To illustrate, consider the steps leading up to the front door of a family's house. Custom determines a standard of safety in maintaining steps. If someone is injured on the steps and sues the homeowner, the court in a common law country will use the customary standard to determine whether or not the homeowner negligently maintained the steps. Similarly, the American Bar Association imposes a code of ethical responsibility on lawyers, and courts hold lawyers liable for some harms resulting from their unethical conduct. In general, intermediate institutions

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[6] Perhaps the leading scholar who advocates centralized legal reform in developing countries is R. B.Seidman. See (Seidman, 1978). Seidman's central theme is that the state reflects conflict and in the 3rd world, where the parties are unequal, the state should side with the weaker party. For his wholesale attack on the application of the modern economic analysis of law to developing countries, see (Makgetla and Seidman, 1989). See also (Marsinghe, M. L., 1984). See discussion in (Marsinghe, 1984).

[7] (Black and Kraackman, 1999) rewrote corporate law for Russia. .

[8] For labor law in Africa, see (Ziskind, 1987); for India, see (Saharay, 1988); for Latin America, see (Karst and Rosen, 1975), p. 31; for Brazil, see (Dolinger and Rosen, 1992).

[9] (Mattick, R, 1992).

[10] (White, E, 1975).

[11] (Neto, P., 1990); (Tripathi, N.M., 1991).

[12] The most forceful advocate of decentralized lawmaking, who writes out of the tradition of Hayek, is Leoni. See (Leoni, 1991) and (Hayek, 1976) Chapter 6, pages 72-87. More recently, this theme has been taken up by (Rubin, P., 1993).

located in-between individuals and the state, such as the American Bar Association, make private rules for their members, which provide a guide when courts assign liability.

Comprehensive reform and piecemeal evolution are two alternatives for modernizing law. When politics leads and the economy follows, I describe the process as "political modernization." Politics leads when state officials plan the law by a relatively centralized process. Comprehensive reform is usually political. Alternatively, when the economy leads and politics follows, I describe the process as "market modernization." The economy leads when intermediate institutions develop new norms and the state subsequently recognizes them as legal obligations. Under market modernization, the law evolves by a relatively decentralized process. Piecemeal evolution is usually a form of market modernization. As I use these terms, "market modernization" does not refer to the modernization of markets, and "political modernization" does not refer to the modernization of politics. Rather, the terms refer to alternative ways to modernize law.

Instead of comprehensive reform, market modernization assigns the state the modest task of creating the conditions for economic competition and selectively enforcing norms that evolve as the economy develops. Creating the conditions for economic competition requires such measures as protecting property rights, repealing regulations that inhibit competition, and protecting freedom of association. Selectively enforcing norms involves identifying the business practices that are fair and efficient, and, under certain conditions, enforcing them with the power of the state. Selective enforcement of social norms requires such measures as enforcing business promises and imposing liability on the parties who cause accidents.

Most countries combine both political modernization and market modernization, but their roles are not equally appreciated. Political modernization proceeds through changes in statutes and executive orders. Market modernization, in contrast, proceeds through changes in customs and intermediate institutions. Whereas statutes are easily read, norms must be discovered through research. Thus the importance of political modernization is easily over-estimated and the importance of market modernization is easily under-estimated.

In fact politicians usually lack the information and motivation to make efficient laws. Officials issue orders easily and extract obedience with difficulty. By promising sweeping results quickly, political modernization runs the risk that the state's ambition will outrun its capacities. I will argue that efficiency requires market modernization of law, just like efficiency requires markets for commodities.

Market modernization and political modernization imply different strategies for aid to developing countries. Political modernization focuses on rules. To produce good rules, developing countries often transplant bodies of law from developed countries with the aid of foreign legal scholars. Whereas political modernization focuses on rules and transplants, market modernization focuses on processes, institutions, and legal education. The process of market modernization involves interaction among business representatives, legal officials, and law scholars, who examine, criticize, and alter rules and interpretations. Institutions involve intermediate organizations such as professional associations, industry groups, consumer associations, and scholarly societies. Legal education provides shared concepts for coordination and dialogue. Thus development aid might focus on developing institutions for scrutinizing law and upgrading law schools. To explain this argument in detail, I will first describe the history of legal modernization in the West.

Legal Modernization in the West

A conventional starting date for modern history is the 18th century, when developments in science and industry greatly increased the pace of social change. These changes in society provoked rapid changes in law. The law had to discover the corporate form of organization, clarify the meaning of "property" for industrial organizations, extend contractual obligations to new financial instruments, extend accident law to the dangers posed by industrial products, allocate losses from bankruptcies in new types of organizations, and develop regulations to protect the environment from new pollutants. To lower the cost of understanding the profusion of new laws, legal scholars had to organize them.

I cannot possibly review the history of each body of modern law. Instead of discussing substantive law, I will focus on process. Comparative lawyers often divide

legal systems with western origins into two fundamental types, common law and civil law, which I will discuss in turn. The common law of England has a continuous history reaching back to the medieval period. Throughout most of its history, English common law developed through a close-knit community of professional lawyers and judges solving cases. According to the legal historian Brian Simpson, the common law has been an institution more than a collection of rules.[13] Not until the 18th century did Blackstone first organize the leading cases of the common law into modern legal categories.

In the 18th century, the common law had to evolve quickly to keep pace with changes in business. An often-cited example of the common law's modernization by the common law process concerns financial instruments. Notes and bills of exchange, which circulated among 18th century merchants as means of payment and credit, raised difficult questions of risk allocation. To illustrate, suppose that A produces and delivers goods to B. On receipt of the goods, B gives a note to A promising to pay a certain sum of money on a future date. A sells B's note to C. In the meantime, B discovers a defect in the goods. Now B holds A's defective product and C holds B's promise to pay for it. Can B refuse to pay C on the grounds that A delivered defective goods? Or, alternatively, must B pay C and then sue A for breach of contract?[14]

Such legal questions became acute with the rapid expansion of commerce in the 18th century. Judge Mansfield is usually credited with supplying most of the answers. Mansfield knew that he did not understand fully how businesses use financial instruments. Consequently, he did not try to invent better rules than the ones in practice. Rather, he carefully scrutinized business and tried to identify and enforce the best practices.[15] His elegant solutions were taught in courses on commercial law long after the relevant financial instruments ceased circulating.[16]

This example from commercial law illustrates legal modernization by the common law process. To illustrate the need of modern economies for other kinds of law,

[13] (Simpson, 1973); (Simpson, 1975).
[14] Here is the common law's answer: A holder in due course takes a promissory note free from the contractual defenses of the maker.
[15] The traditional account of the assimilation of bills of exchange and negotiable instruments into common law is developed in (Holden, 1955). Holden is criticized in (Baker, 1979).

consider these four fundamental legal developments. First, the resources used by complex organizations come from various sources. The owners of resources who advance them for use by others assume risk. The law of contracts, corporations, and bankruptcy keeps risk lows enough so that people willingly supply resources to each other. Second, an efficient organization needs to extract effort and creativity from its workers. Contract law and labor law help organizations to create incentives that motivate workers. Third, without competition, large organizations lapse into bureaucratic lethargy. Property law and antitrust law provide a framework for sustained competition. Finally, as goods become more complex, exchanging them uses more resources. Contract law and commercial law lower these transaction costs. Each of these areas of law had to evolve rapidly in the 18th century to produce modern common law.

In common law systems, intensive litigation alerts judges to the need to change the law.[17] Empirical evidence indicates an intensification of litigation around the time that judges adopt a new precedent.[18] Judges respond to a proliferation of novel disputes by making new law.[19] Thus the priorities for legal development in a common law system are determined by litigation rates. When judges make common law, however, they cannot do as they please.[20] According to an old principle in jurisprudence, judges cannot make law except when they find a social norm worthy of enforcement by the state. This principle is embodied in the saying, "Rather than *making* common law, judges *find* it."[21] Thus Judge Mansfield examined the commercial practices of his day in order to find the foundations of modern commercial law.

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[16] I refer especially to Article 3 of the Uniform Commercial Code, which was taught in American law schools long after the instruments to which it applied ceased to circulate.

[17] Models of the evolution of the common law towards efficiency are often based upon a bias in litigation favoring more intensive and extensive challenges to inefficient laws. The first paper is (Rubin,P., 1977); for a review of proposed mechanisms and their mathematical testing, see (Cooter and Kornhauser, 1980).

[18] See (Priest, 1987). Note, however, that the evidence is unclear as to whether intensified litigation precedes a new precendent, follows a new precedent, or both. See (Cooter, 1987).

[19] (Eisenberg, 1988)

[20] This is the subject of a famous critique of H.L.A. Hart's theory of positive law by Dworkin. See (Hart, 1961), and (Dworkin, 1977).

[21] For an exposition of this old view of lawmaking, see (Davies, 1986). In a recent article, Ed Rubin traces this line of thought to a belief in medieval Europe that law is at once divine and natural. (Rubin,E., 1995). This older view finds an echo in the jurisprudence of Ronald Dworkin, (Dworkin, 1977), who asserts that courts should find rights and not make policy.

Since the 18th century, common law countries have developed new institutions to aid the law's evolution. Organizations conduct studies to scrutinize current law and issue reports recommending changes in it. In Britain, the law commissions perform these tasks,[22] and in America these tasks belong to the American Law Institute (ALI) and the National Commission on Uniform State Laws (NCUSL).[23] To illustrate the work of these bodies, the American Law Institute periodically creates ad hoc committees of scholars and lawyers to restate the best practices of courts in particular areas of law, such as the Restatement of Torts (1977) or the Restatement of Contracts (2nd, 1979). Restatements serve as references for judges, which increase uniformity across jurisdictions and speed the pace of legal change.

Already in the 18th century, a debate was joined in England over whether the common law was efficient or archaic. Did it embody practices that were best or obsolete?[24] The reforming spirit prevailed in continental Europe. Before the Napoleonic revolutions, continental Europe possessed a kind of common law called the *ius commune.* Scholars and judges developed the ius commune by elaborating Roman law in light of local traditions and ongoing realities. Common law, however, was identified with the losing side in the revolutions that brought Napoleon and his followers to power. The victorious revolutionaries, who regarded judges with suspicion for upholding the old regime, wanted to uproot "medieval" practices and replaced them with "rational" ones. The revolutionaries proclaimed that law derives its authority from the popular will as expressed through legislators, not from social norms as found by judges.[25] The popular will was identified with rationality, whereas social norms were identified with habits. Commissions were appointed to draft codes to supercede the common law. Scholars on the commissions examined pre-revolutionary law with a critical eye, retaining some and rejecting the rest. Legislators enacted the codes into law.

Compared to common law countries, the codifiers in civil law countries apparently have more influence and judges have less influence. Judges allegedly make

[22] (Ogus, 1995).
[23] (Schwartz and Scott, 1995).
[24] This debate was joined in the famous attacks of Bentham on the common law. For a modern discussion that reherses this old debate, see (Posner, 1979).
[25] (Dawson, 1972).

law in civil systems by interpreting codes, not finding social norms. Interpreting some codes, however, looks so much like finding social norms that comparative lawyers debate whether this apparent difference form common law is real or illusory.[26].

To illustrate how norms can influence codes, consider a code that I alluded to earlier. I already discussed the fact that the American Laws Institute (ALI) and the National Commission on Uniform State Laws (NCUSL) create committees to restate the common law in the USA. In addition, these bodies create committees to draft model codes. The most successful example is the Uniform Commercial Code (UCC), which applies to contracts among merchants, financial instruments, and bankruptcy. Its drafting was directed by a famous professor of law, Karl Llewellyn, who tried to identify and articulate the best commercial practices in contemporary business communities, much like Lord Mansfield when he modernized British commercial law.[27] After Llewellyn's committees completed their work, the Uniform Commercial Code was presented to the legislatures of the American states, which enacted it into law. When legislation and common law apply to the same case, legislation prevails, so the UCC displaced much of the common law for commercial transactions. Judges continue to make commercial law in the United States by interpreting the UCC. Furthermore, many provisions of UCC are based on the insight of the drafters into the best commercial practices. Consequently, making law by interpretation of the UCC closely resembles the process by which common law evolves.

Both common law and civil codes rely heavily on broad principles that apply in many different circumstances. These principles ideally abstract from particular practices, and the practices give specific content to the principles. To illustrate by an earlier example, the common law of torts typically holds injurers liable for accidents caused by their negligence, and this general principle receives specific content by reference to the actual standards by which particular communities evaluate accidents. When judges apply the negligence principle, they often find the specific standard applicable to the case by identifying the standards of the relevant community. Civil law judges can proceed on

[26] (Cooter and Gordley, 1991). The dispute is difficult to resolve because, in reality, neither system exists as a pure type. In common law countries, restatements and codes have legal authority, and judges in civil law countries are influenced by social norms.

similar lines when interpreting general principles in a code. For example, "negligence" in civil law can receive specific content by reference to community practices. By relying on judges to use specific practices to interpret general principles, common and civil law empower judges to make law from community norms.

Before leaving civil law, I should jump forward in history and mention a remarkable recent development. As I explained, 19th century nationalism shattered Europe's common law and replaced it with separate civil codes for each nation. The unification of government under the European Union, however, has induced an effort to resurrect Europe's common law. Some European legal scholars hope to unify European private law by restoring the discarded *ius commune*.[28]

In the 20th century, a massive growth of new law in the industrial countries of Europe and America created the regulatory state. The regulatory state replaced some old laws with new regulations, such as replacing the common law of crimes with criminal codes. The regulatory state also created entirely new bodies of law, such as administrative law. Having discussed common and civil law, now I turn to regulations. As before, I focus on the process of making regulations, not on the substance.

Whereas a community of scholars, lawyers, and judges typically produces the common law and much of the civil law, politicians and bureaucrats have more influence on regulations. Regulations can come from the legislature, the executive, or the bureaucracy. Legislatures produce regulations by familiar processes: committee hearings, debates, bargaining, and majority voting. Executives promulgate rules directly by issuing executive orders or indirectly by having ministries issue regulations. Ministries usually follow procedures prescribed in legislation for making regulations, which differ from one agency to another and from one country to another.[29] When US agencies create new regulations, they must follow procedures stipulated in the legislation conveying authority upon them. In the absence of such stipulations, they must follow procedures

[27](Hillinger, 1985).
[28] The leading proponent is (Zimmermann, 1990).
[29] For a study of German and US administrative law, see (Rose-Ackerman, 1994).

prescribed in the Administrative Procedures Act.[30] To illustrate the US Environmental Protection Agency would follow regulatory procedures prescribed in the National Environmental Policy Act of 1969, or, in the absence of specific legislative instructions, it must follow the Administrative Procedures Act.

In addition to the difference in process, regulations tend to be drafted differently from the common law or codes. As explained, the common law and codes rely heavily on general principles whose specific content comes from community practices. In so far as regulations are imposed from the top, they lack a foundation in community practices. Without such a foundation, the regulators would create uncertainty by promulgating *general* principles. Instead of promulgating general principles, regulations rely more heavily on explicit, detailed instructions. For example, instead of requiring the rungs of ladders to be "reasonably strong" or "strong enough for their intended purposes," a regulation might specify exactly how many kilograms of vertical weight a rung must be capable of supporting.

Although the regulatory state did not stop the evolution of the common law,[31] its development impressed some scholars so much that they detect movement in modern history towards centralized regulation. Salmond asserted that customary law is important in the early stages of legal development, but gradually cedes its place to statutes when "the state has grown to its full strength."[32] In a recent article, Ott and Schafer point out that modern German law has moved away from customary law and towards statute as the basis of business law.[33] Schaefer has also developed an interesting

[30]The APA distinguishes two fundamental types of procedures for two different types of regulations. The two types are called "adjudicatory regulations" and "legislative regulations." This distinction is developed especially in Overton Park and Vermont Yankee. Citizens to Preserve Overton Park, Inc., et al. v. Volpe, Secretary of State, et al., 401 U.S. 402, 91 S. Ct. 814, 28 L. Ed. 2d, 136 (1971). Vermont Yankee Nuclear Power Corp. v. Natural Resources DefenseCouncil, 435 U.S. 519, 985 S. Ct. 1197, 55 L. Ed. 2d, 460.

[31]For a view of how the new world of regulations interfaces with the older world of free contract, see (Calabresi, 1976).

[32](Salmond,1966)at pages 66-67. Note also that Peter Stein writes: "Roman law, like most legal systems, begins as a set of orally transmitted traditional norms and written law begins as written custom." See (Stein, 1995), at page 1.

[33](Ott and Schaefer, 1991). In making these remarks, they are describing history, not passing judgment upon it.

argument that developing countries can economize on scarce human resources by replacing general principles of law with precise regulations.[34]

Communism

The most complete legal reforms in the 20th century were carried out by communist revolutionaries, who swept away the law, politics, and economics of the old regimes even more thoroughly than the 18th century revolutionaries did, and replaced it with central planning. Under central planning, government officials formulate the state's goals for the production of commodities, embody the goals in production targets, and order people to meet them. Orders move along a one-way street from top to bottom. To implement production targets, officials need the power to allocate resources. To possess this power, the orders issued by officials must trump the private rights of citizens. In communist countries, the state repealed or emasculated private law in employment relations, land ownership, antitrust, consumer products liability, and worker safety. Once these legal impediments were removed, officials ruled by decree. So, central planning is a way of making law as well as commodities.

Some formerly communist countries are trying to recover legal traditions that were lost in revolutions. National and foreign scholars are drafting new laws for the formerly communist countries, with funding and prodding from international agencies. It seems that each Eastern European country will build private law from their pre-revolutionary codes and the law of the country supplying funding for legal reform.[35] Many formerly communist countries have transplanted bodies of civil law from whichever donor country paid for the transplant.Medjad has concluded that legal transplants to formerly communist countries are driven by the supply of the donor, not the demand of the donee.[36]

Diffusion

[34] (Schaefer, H.-B., 2002). Rule Based Legal Systems as a Substitute for Human Capital. Should poor countries have a more rule based legal system? Berkeley Law and Economics Workshop, April 8 2002.
[35] A useful review is in (Cadwell, 1995). Also see (Stephan, 1995).
[36] (Medjad, K., 2000).

Economic law diffused from western nations to the rest of the world by force of arms and example. British common law applied to British colonies; the French civil code applied to French colonies; Latin American countries typically adopted American constitutional law and European civil law; Japan, Korea, and Taiwan voluntarily adopted versions of the German civil code. Everywhere, imported western law confronted indigenous rules, and different compromises between them were struck in different countries. For example, in Japan the form of civil law was German but the substance was distinctly Japanese.

The urgent need to modernize law in developing countries, combined with the influence of socialism and statism, produced a torrent of high-minded legislation in Africa, the Indian subcontinent, and Latin America. Similar processes are at work in post-communist countries. Since the demise of the Soviet Union, many countries are renouncing communist law in favor of western models, and the particular western model chosen often depends on the vagaries of politics and the foreign or international agency funding the legal reform.[37] In general, this torrent of legislation is not based on social norms enforced by intermediate institutions. Instead, implementation of the legislation requires a large bureaucracy. The bureaucracy imposes a burden of taxation and corruption on the economy.[38] In addition, the bureaucracy undermines legality by substituting regulations for private law.

Comparing Four Sources of Law

I have briefly described four sources of economic law: common law, civil law, the regulatory state, and communism. The common law process exemplifies the decentralized, evolutionary approach that I call market modernization. The regulatory state exemplifies the centralized, planned approach that I call political modernization. Communism takes central planning to its logical extreme. The civil law process can go

[37] (Cadwell, 1995).

[38] In (Trebilcock, 1995), at page 37, the author writes: "Despite the prominent role that SOEs play in most developing countries' economies, they typically perform poorly and require substantial ongoing government subsidies." At pages 35-36, he says "The empirical evidence tends to suggest that heavily regulated, protected, or subsidized private monopolies are unlikely to perform much better than publicly owned monopolies"

in either direction, depending on whether the codes enforce social norms or invent new regulations.

Information and Norms

Earlier I referred to the 18th century debate over whether the common law is a flexible and efficient legal order, or an archaic residue of obsolete practices. The economic analysis of law has revealed more consistency between the common law and efficiency than anyone anticipated when the intellectual enterprise first began in the 1960s.[39] Since judges seldom explicitly decide cases on grounds of efficiency, these facts raise the question, "What is the hidden hand that directs the common law towards efficiency?" This question has provoked a lively exchange of ideas among legal scholars.[40] A simple mechanism provides the answer. Assume that intermediate institutions work well enough so that they create social norms that evolve towards efficiency. If social norms evolve towards efficiency, and judges enforce social norms, then the common law will evolve towards efficiency.[41] This mechanism, which inspired Mansfield's modernization of commercial law and Llewellyn's organization of the UCC, can also operate in a civil law system through the revision of codes and their interpretation in light of social norms.

I will explain why efficiency requires market modernization of law, not just political modernization. The modern economy creates many specialized business communities. These communities may form around a technology such as computer software, a body of knowledge such as accounting, or a particular product such as credit cards. Wherever there are such communities, norms arise to coordinate the interaction of people. The formality of the norms varies from one business to another. Self-regulating professions, such as law and accounting, and formal networks, such as Visa, promulgate their own rules. Voluntary associations, such as the Association of Home Appliance

[39] Footnoting all the efficiency models would require footnoting almost the entire economic analysis of law. For more detail, see either of these text books: (Posner, R., 1992) or (Cooter and Tom Ulen, 1988). Skepticism about the whole enterprise persists in some quarters, especially within the critical legal studies movement. Mark Kelman has argued in a series of papers that the economic analysis of law is ideologically motivated. See, for example, (Kelman, 1988).
[40] (Rubin, 1977); (Priest, 1977); (Goodman, 1978); (Cooter, 1980); (Rubin, 1993).
[41] See (Cooter, 1994).

Manufacturers, issue guidelines. Informal networks, such as computer software manufacturers, have inchoate ethical standards. The modern economy creates many specialized business communities, whose norms I have called "the new law merchant."[42]

As an economy develops and law becomes more complex, citizens need more information about law to obey it. Obtaining specialized information requires costly legal counsel. Alignment of state law with social norms enables citizens to economize on legal counsel by taking morality as a guide to legality. Thus aligning state law with morality promoted rational ignorance of the law, whereas misalignment promotes costs expenditures on understanding law.

Sociology has accumulated a large body of evidence indicating that ordinary US citizens and many businesses actually know little about the legal consequences of their acts. For example, American businessmen often sign contracts without understanding their legal implication, take risks without knowing their legal liability, or invest in property improvements without knowing their ownership rights.[43] Similarly, borrowing by small business in Taiwan often occurs outside of formal law,[44] and many Peruvian businesses systematically break the law to circumvent excessive regulations.[45]

As an economy develops and law becomes more complex, officials need more information to make laws and enforce them. Citizens supply essential information to prosecutors and police, such as filing complaints against lawbreakers and testifying in prosecutions. When state laws respond to social norms, private citizens take risks or use their resources to help officials enforce state law. Citizens enforce social norms by informal punishments such as gossip, rebukes, and shunning. In contrast, private citizens are reluctant to help officials enforce laws perceived as unjust or irrelevant. When state law conflicts with social norms in such areas as contracts, property, and torts, citizens and businesses often disobey state law out of ignorance or willfulness and follow morality instead.

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[42] (Cooter, 1996).
[43] (McCauley, 1963).
[44] (Jane Kaufman Winn, 1994).
[45] (de Soto, H., 1989), translated by June Abbott.

As an economy develops, the information and motivation constraints on state laws tighten. Aligning state law with social norms loosens the information constraints on government in a growing economy. Conversely, if law becomes unaligned with social norms, the constraints on information created by a growing economy tighten further.

Informal and Formal Social Norms

In general, legal systems have primary rules that regulate the behavior of citizens and secondary rules that specify the process for making, amending, or extinguishing primary laws. To illustrate, the U.S. Constitution specifies that a bill becomes law when it receives a majority vote in both houses of Congress and the signature of the President. Similarly, many private organizations have charters that specify how to make rules. To illustrate, the charter of a corporation may empower its board of directors to impose rules on employees, and the bylaws of a church may empower its deacons to impose rules on members.

The least formal social norms, however, lack secondary rules. To illustrate, no definite process exists to create, amend, or extinguish a rule of etiquette or a principle of morality. The least formal social norms are the polar opposite of state laws, which are the most formal norms. In order to draw the sharpest contrast between law and social norms, I will focus on the least formal social norms. The sharp contrast between formal state law and informal social norms helps to explain the relative advantages and disadvantages of law and morality as means of social control.

Proponents of decentralization have long admired social norms because they arise spontaneously outside the state.[46] More recently, the formal analysis of social norms developed through the application of game theory.[47] The economic analysis of social norms draw on a fundamental result in game theory: One-shot games with inefficient solutions, such as prisoner's dilemma, often have efficient solutions when repeated between the same players.[48] This generalization grounds the "utilitarianism of small

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46 Hayek, F.A., 1976); and (Leoni, B., 1991).

47 (Ullmann-Margalit, E.,1977); (Sugden, R., 1984); (Hirschleifer, J., 1982); and (Taylor, M., 1987).

48 (Fudenberg, D. and Eric Maskin, 1986); and (Axelrod, R., 1984).

groups," by which I mean the tendency of small groups to develop efficient rules for cooperation among members.

The utilitarianism of small groups has been demonstrated for cattle ranchers, Chinese traders, medieval merchants, and contemporary diamond merchants.[49] Research on property rights has revealed variety and detail in the political arrangements by which small groups manage their assets.[50] Note that utilitarianism applies to social groups in which people have repeated transactions with each other, but not to social categories that classify together people who seldom interact with each other.[51] Furthermore, one group may develop norms that benefit its members by subordinating people from other groups.[52]

I have been discussing informal social norms. Some private companies, however, supply governance, which involves making laws, adjudicating disputes, and enforcing decisions. For example, the Visa corporation revises its operating rules by a legislative process, resolves disputes through its arbitration committee, and enforces decisions against its members.[53] Much the same is true of the diamond exchanges.[54] Each of these organizations encompasses one highly organized industry, whereas many business contracts extend across industries. Arbitration associations and similar organizations that serve business typically adjudicate disputes and do not enforce decisions or make laws. In principle, private organizations could supply governance to general business. Like any other service, governance could be provided at a fee by contract. For business in general, however, a fully developed private alternative to public law does not exist.

Business contracts often stipulate mediators or arbitrators to resolve future disputes. For example, American contracts often stipulate that disputes will be resolved by the American Arbitration Association, and international contracts often stipulate that disputes will be resolved by the International Chamber of Commerce in Paris. Most

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49 Cattle ranchers, see (Ellickson, *R.*, 1991); Chinese traders see (Landa, J., 1981) and (Landa, J., 1983); Medevial merchants see (Milgrom, P., D. North and B. Weingast, 1990) and (Greif, A.,1993); Contemporary diamond merchants see (Bernstein, L., 1992).

50 (Eggertsson, T., 1992); (McCloskey, D.N., 1975) and; (McCloskey, D.N., 1975); Ostrom, E.,1990); and (Ellickson, R., 1993).

51 (Posner, E.,1996).

52 (Akerlof, G., 1980); (Akerlof, G., 1985); and (McAdams, R.H., 1995).

53 (Rubin, E. L. and R. Cooter, 1994).

countries have signed the New York convention, which commits national courts to the enforcement of such arbitration clauses. As opposed to public trials, private arbitration proceeds quickly, dispenses with costly procedures, and leaves decisions to business experts.[55] However, the terms in the contract stipulating private resolution of disputes may itself become the subject of dispute, in which case the parties must resort to a public court. Thus the public court supplements the private forum for resolving disputes.

Judicial Independence

Market modernization of law requires the judges to interpret and make law so that it aligns with social and business norms. Norms embody concepts of justice and fairness. So market modernization requires judges to interpret and make according to concepts of justice and fairness. How can a state get such judges?

The executive and legislative branches of the state are necessarily political, whereas the judiciary and the civil service are not necessarily political. Market modernization of law must rest on the independence of the judiciary and the civil service. Independence implies that politicians cannot influence the power and wealth of judges and bureaucrats. State bureaucrats are shielded from politics by the usual civil service techniques, such as a prescribed hierarchy, income and power based on rank in it, demotion or dismissal restricted to narrowly defined causes (incompetence, gross immorality, corruption), promotion based on objective examinations and evaluations by superiors, prohibitions against contacts with politicians, and so forth.

For the judiciary, different countries try to achieve independence by different means. In continental Europe, judges belong to the civil service, so they enjoy the same protections from politics as other civil servants, plus some additional protections created by more restrictive rules. The US federal courts, in contrast, follow an entirely different path to independence. Whereas the civil service strives to make the wealth and power of officials independent of *politics*, US federal courts strive to make the wealth and power of judges independent of *performance*. After undergoing a highly political process of appointment by the US President, federal judges serve for life at rigidly prescribed

[54] (Bernstein, L.,1992).

salaries. Their communications with politicians are tightly circumscribed; their assets are placed in "blind trusts"; and they cannot hear cases affecting their material interests. Attempts by econometricians to find the causes of promotion of federal judges from the district courts to the circuit courts of appeals, or from the district or circuit courts to the Supreme Court, have failed to identify any variables under the control of the judges.[56] Apparently, the promotion process is random. These facts suggest that US federal judges, in addition to being independent from politics, are *disinterested* in the sense that their performance does not affect their materials interests.

Game theory has suggested reasons why politicians might wish to create an independent judiciary or even a disinterested judiciary. Like business contracts, political contracts require enforcement by an unbiased third party. Landes and Posner argue that political interest groups, who strike bargains in order to enact legislation, need an independent judiciary to provide unbiased interpretation of their deals.[57] Thus, when politicians know that they will have to bargain with each other, they tend to create an independent judiciary.

Bargaining among politicians relates to constitutional and political variables. On the constitutional side, the division of powers between the executive and legislature, or between the two houses of a legislature, or between the federal government and state governments, creates the need for the branches of government to bargain with each other. Furthermore, as they increase their independence from politicians, judges become more adventurous in their decisions and they make more laws with greater scope. Thus the application of game theory to constitutional law predicts that courts will be more independent and adventurous in a bicameral system than in a unicameral system, and courts will be more independent and adventurous in a presidential system than in a parliamentary system. To illustrate, this theory predicts more adventurous courts in the US (bicameral, presidential) than in the United Kingdom (unicameral, parliamentary).[58]

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[55] (Schmitthoff, 1983)
[56] (Higgins, 1980) (Posner, 1993) For elected judges, the situation may be different, as demonstrated in (Dubois, 1984)
[57] (Landes, 1975)
[58] (Ferejohn, 1992); (Cooter, 1994).

Turning from the constitution to politics, a dominant, disciplined party that retains power for a long period of time need not bargain with other parties. Conversely, fragmentation among political parties causes them to bargain with each other. The parties need to bargain with each other when unstable coalitions form governments or when the government changes frequently due to regular, close elections. Thus the theory predicts that a state with fragmented parties or parties alternating in power will give the judiciary more independence than a state with a dominant, disciplined political party.[59] To illustrate, since the end of the Second World War, Italy has had more than one government per year, whereas Sweden had relatively few changes in its government, so the model predicts that Italian courts will be more adventurous during this period than Swedish courts.

Ramseyer uses this model to contrast the legal history of Japan and the US. He concludes that politicians foster independent courts when they expect elections to continue and they do not expect to win all of the elections. Thus, when electoral government was coming to an end in Japan in the 1920s, politicians interfered with the court. Similarly, the LDP, which ruled Japan continuously from 1955 to 1993, politicized court promotions. In contrast, after the early years of the 19th century, the US settled into a stable pattern of two party competition, and the two parties facilitated the development of judicial independence.[60]

Another approach to corruption focuses on the struggle between officials who benefit from corruption's persistence and the officials who would benefit from its elimination. Olson has argued that a strongman who acquired a monopoly on force could profit more from recognizing property rights and collecting taxes, rather than looting the property of others.[61] Generalizing Olson's view, perhaps the leadership at the center of the state can increase the resources at its command by substituting taxes for bribes as the means of financing government.

Support for this conclusion comes from an analogy between narrow taxes and bribes. A very narrow tax applies to a particular good purchased by a particular

[59] (Cooter, 1995).
[60] (Ramseyer, 1997).
[61] (Olson, 1991).

individual. A bribe paid to an official is much like a tax levied on a particular individual who wants a particular good from the state. According to a central principle in public finance, broad-based taxes raise more revenues with less distortion than narrow-based taxes.[62] Broad-based taxes distort behavior less because people can do less to avoid paying them. To illustrate, a tax on carrots is narrower than a tax on vegetables; consumers substitute other foods more easily for carrots than for vegetables; a tax on vegetables can raise more taxes with less distortion than a tax on carrots. (In the technical terms of Ramsey's classical formulation, the optimal tax on a good is inversely proportional to its elasticity of demand.[63]) As with narrow taxes, individuals can do a lot to reduce the probability and magnitude of the bribes that they must pay, such as cultivating friends in government, or investing in different lines of business. Consequently, bribes badly distort behavior. Because of the distortions, bribes are less efficient than broad-based taxes as a means of raising revenues for state officials.

If this argument is correct, the state can substitute taxes for bribes and raise more money for itself without increasing the burden on the economy. So why don't all states suppress corruption? Economics is just beginning to explain why some officials are corrupt in all countries and most officials are corrupt in some countries. Two kinds of reasons have been offered. First, officials may be unable to cooperate sufficiently among themselves to eliminate corruption. Rasmusen and Ramseyer have developed this argument for legislatures. They argue that, under certain circumstances, it pays individual legislators to accept bribes of less value than their cost to the legislature as a whole. Under these circumstances, it pays the legislature as a whole to suppress the taking of bribes by its members. (In technical terms, taking bribes is a Pareto inferior Nash equilibrium.) The members can make themselves better off by acting collectively to prevent any of them from taking bribes. To act collectively, the legislature needs institutions that can monitor and punish its members for taking bribes, such as an ethics

[62] This basic principle is developed in any public finance text. For example, see (Musgrave, 1959).
[63] See (Musgrave, 1959) at 62.

committee and a strong chairman.[64] Thus this theory predicts that the legislature will suppress corruption when it can solve its own problem of collective action.

This example simplifies the truth by assuming that everyone in the legislature benefits from a collective decision to end corruption. In reality, some officials benefit from ending corruption and other officials benefit from its persistence. The actual pattern of winners and losers depends on institutional details and historical particularities. One possibility is that substituting taxes for bribes, which strengthens the state as a whole, benefits the officials at the center who control the state, and harms many lower-level officials who rely on income from bribes. To illustrate, Andras Sajo argues that the people of eastern Europe think of central government as the only possible source of legality that could oppose local corruption.[65] To eliminate corruption among lower level officials, the center must create an employment contract for civil servants that creates disincentives for bribe-taking. In general, the high-level officials want to create an employment contract for low-level officials such that they serve their best interests by doing what is best for the high-level officials, including not taking bribes. Economists refer to such an employment contract as "solving the agency problem."[66] Presumably the civil service solves the agency problem when it has the means to discipline its members. Thus this theory predicts that the state will purge itself of corruption when it can collect taxes and discipline the civil service.

Conclusion on Market Modernization of Law

The theory of social norms has some practical implications for economic development. In a developing economy with relatively free trade, business will tend to develop efficient norms to regulate private interactions. In these circumstances, the role of state law can be limited to correcting failures in the market for norms. Failures tend to occur because private, informal punishment insufficiently deters wrongdoing. In these circumstances, state enforcement of social norms can increase private cooperation and

[64] According to Rasmusen and Ramseyer, whether legislatures encourage bribes or suppress them depends on the size of legislatures, the quality of voter information, the nature of party organization, and the structure of committees. (Rasmusen, 1993).
[65] (Sajo, 1993).
[66] (Shavell, 1979); (Arrow, 1985).

production. However, successful state enforcement typically requires a close alignment of law with morality, so state officials enjoy informal support from private persons.

Business law and morality especially get out of alignment in states suffering from legal centrism, such as over-regulation or central planning. In these circumstances, the re-alignment of business law with morality is needed to reduce corruption and create the private basis for effective public laws. To re-align business law with morality, business law should be remade to reflect the best business practices.

I have emphasized the advantages and not the disadvantages of market modernization. I should mention in passing some complexities and potential problems. First, business contracts written to end failed relationships seldom embody the norms that sustain successful relationships. These so-called "endgame" contracts should be interpreted strictly.[67] Second, social norms are often vague, especially when changing. To illustrate, are Americans still obligated to hold the fork in the right hand when eating, or is the European practice of holding the fork in the left hand now acceptable in America? Some critics of the role of norms argue for the unduly pessimistic view that they are too indefinite to be useful in adjudication.[68] In order to distinguish between them, we do not require a line separating a person's face from the back of his head. Third, social norms often involve the kind of interdependency that causes multiple equilibria. Given this fact, the law might play a crucial role in determining the outcome by influencing peoples' beliefs about what others will do, rather than merely by deterring people by the threat of sanctions.[69]

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[67] To illustrate, businessmen often write contracts and pay little attention to them. The exact terms of the contract, however, become important when a business relationship goes bad and comes to an end. Many contracts are written to use to dissolve bad relationships, not to sustain good relationships. A lively debate persists about the extent to which contracts generally should be interpreted strictly as written, as especially favored by British courts, or interpreted more loosely in light of business practice, as especially favored by American courts. Endgame contracts favor the British practice. The person most responsible for these ideas is Lisa Bernstein.

[68] (Craswell, R.,1999).

[69] To illustrate, assume the state wants citizens to obey the social norm. If the state is careful about its pronouncements, so that most citizens believe them, then the state might cause the system to converge to the preferred equilibrium. A credible state can influence the choice of multiple equilibria among citizens by pronouncing the law. The expressive power of the law derives from pre-existing multiple equilibria in the underlying system of social interactions. (Cooter, 1998a) (Adler, 1999); (Feinburg, 1990); (Sunstein, 1996); (Pildes, 1998); (Cooter, 1998a); (Hampton, 1992); (Kahan, 1997a); (Kahan, 1997b)

Most countries combine both political modernization and market modernization, but their roles are not equally appreciated. Political modernization proceeds through changes in statutes and executive orders, which politicians trumpet to their constituents and government offices publish for easy access by scholars. Market modernization, in contrast, proceeds through changes in customs and intermediate institutions, whose discovery requires research. Thus the importance of political modernization is easily over-estimated and the importance of market modernization is easily under-estimated.

II. Median Democracy[70]

The philosophy of mercantilism, which prevailed in Europe until the late 18th century, praised monopoly as a device to enrich the state. By convention, modern economics originates with Adam Smith's attack on mercantilism in his book The Wealth of Nations (1776), that praises competition as a device for enriching the nation. In social science's most famous metaphor, Smith proposed that competition directs the butcher and baker, who look only to their own advantage, to maximize the nation's wealth, as if directed by an "invisible hand". A century passed before the marginalist revolution of the late 19th century mathematically formulated this metaphor.[71] Mathematical improvements culminated in general equilibrium theory in the 1950s and 1960s, which provides a rigorous defense of competitive markets and a framework for analyzing market failures.[72] Subsequent developments in game theory detailed more precisely how competition usually works and sometimes fails.[73]

In 1776, the same year that Adam Smith published his most famous book, the United States issued its Declaration of Independence. Many Americans hoped to create the world's first mass democracy. After a false start, the present U.S. constitution was adopted, which some of its framers described as a machine for good government by self-

[70] The Optimal Number of Governments for Economic Development. This paper draws on my book, (Cooter, 2000), Part II. This paper was written for IRIS Conference entitled "Market Augmenting Government", March 1999, Washington, D.C. I would like to thank Martin McGuire and other participants in the IRIS conference on market-augmenting government for comments on the first draft of this paper. I also benefited from comments by members of the American Law and Economics Association and the Comparative Law and Economics Forum.

[71] (Blaug, 1978); (Schumpeter, 1986).

72 (Arrow and Hahn, 1971)

73 (Fudenberg and Tirole, 1991).

interested people.[74] Judging from the Wealth of Nations and the U.S. constitution, the ideal of competition began its ascent in economics and politics at roughly the same time. Two hundred years later, with the collapse of communism after 1988, the principle of competition dominates the world's economic and political institutions, as well as dominating economic and political theory. At least for a while, capitalism and democracy lack serious rivals.

Competitive markets cause private businesses to supply abundant private goods at low prices. Similarly, competitive elections ideally cause public institutions to supply abundant public goods with low taxes. Market competition satisfies the preferences of consumers for commodities better than an economic cartel, and political competition satisfies the preferences of citizens for laws and public goods better than a political cartel. Specifically, elections (democracy) satisfy the citizens more than a self-perpetuating bureaucracy (civil-service state), a dominant social class (aristocracy), a ruling family (monarchy), an all-powerful individual (dictatorship), a priestly caste (theocracy), or a vanguard party (communism).

Whereas Adam Smith intuited the efficiency of market competition, general equilibrium theory proved it. Ideally, the economic analysis of politics would do for democracy what general equilibrium theory did for capitalism – prove that competition best satisfies the preferences of citizens. But is the efficiency of political competition provable? From the beginning, attempted proofs encountered difficulties. Instead of positive proof, mathematical theories discovered impossibility theorems demonstrating the limits of democracy. Decisions over public goods require collective choices, and Arrow proved that a no democratic constitution can guarantee stable, Pareto efficient collective choices (Arrow 1963). Competition does not produce good results as predictably in politics as in economics. Unlike the economy, irreducible power and unending redistribution destabilize cooperation in politics. When cooperation collapses, selfishness destroys instead of energizing.

74 See, for example, (Madison, 1981b) page 160. Or see the letter from John Adams to Richard Henry Lee, Nov. 15, 1775, reprinted in (Adams, 1851), quoted in (Krasnow, 1991).

Making, amending, and interpreting constitutions is a political game that can lead to widespread suffering or secure a nation's liberty and prosperity. The "efficient constitution" maximizes the satisfaction that citizens obtain from public laws and public goods. Democracy is competitive government, and electoral competition directs the energies of politicians to advancing the goals of citizens.

What kind of democracy is most efficient? I contrast two types. "Median democracy" is a system where the center of the political spectrum prevails on each issue. Median democracy especially involves direct democracy, special districts for particular public goods, and the election of the executive. Through median democracy, the political center imposes stability on government. The drawback with median democracy is that political trades are more difficult. Alternatively, "bargain democracy" is a system where the representatives of the citizens bargain for laws and public goods. Bargain democracy especially involves indirect democracy, unified government, and a Parliamentary system. Through bargain democracy different groups can realize the gains from political trades. Also, bargain democracy can dissipate the nation's wealth in an unstable power struggle. I will argue that states suffering from political instability should promote median democracy by favoring referenda, special governments for particular public goods, and direct election of the executive.

Processes of Government: Electing, Bargaining, Administering

In a democracy candidates compete for office and the votes of citizens determine the winners. To win elections and form governments, politicians must bargain with each other and agree to cooperate. Once a government forms, it implements its policies through state bureaucracies. So electing, bargaining, and administering are three basic government processes. I will describe briefly some major conclusions about these processes.

When constitutions narrow voting to one dimension of choice, majority voting tends to settle towards the middle of the distribution of voters' preferences. Like a safe stock, one-dimensional choice has a modest, predictable yield. Alternatively, constitutions can allow voting to range freely over multiple dimensions of choice. Multiple dimensions of choice lower the transaction costs of political trades, with two

possible results. First, politicians often bargain successfully and "roll logs." Just as people benefit most from trading widely in markets, so political factions benefit most from bargaining widely in politics. Second, bargaining among politicians may fail, with the consequence that majority voting spins its wheels. No one benefits from wheel-spinning. Like a risk stock, multi-dimensional choice can yield a lot or nothing, depending on political institutional and culture.

The citizens under the jurisdiction of a government might have complementary tastes in public goods. To illustrate, consider an example with two citizens A and B, and two public goods X and Y. If A intensely wants X and feels indifferent about Y, whereas B intensely wants Y and feels indifferent about X, then A and B have complementary tastes for X and Y. A and B can cut a deal to help satisfy their most intense desires. B supports A's efforts to obtain X, and A supports B's efforts to obtain Y.[75] The scope of complements determines the potential gain from political bargains. When different political factions have complementary tastes for public goods, splicing lowers the transaction costs of political bargains, thus increasing the probability of a bargain and the size of the resulting surplus

Citizens, however, may have non-complementary tastes. To illustrate, if A intensely likes X and B intensely dislikes X, then A and B have non-complementary tastes for X. The differences in preferences of A and B for X provide no basis for them to cut a deal. Given purely non-complementary preferences, politics becomes a game of pure conflict in which one player's win is another's loss.

By definition, the *core* of a game is the set of unblocked distributions. Since every proposal is blocked by an alternative, the game has an empty core. Majority rule games of distribution with symmetrical players generally have an empty core. To see why, assume that three voters, denoted A, B, and C, must distribute $100 among them by majority rule. Initially, someone proposes to divide the money equally: (A,B,C)=($33,$33,$33). A's counter-proposal is to share the surplus equally with B and give nothing to C: (A,B,C)=($50,$50,$0). A and B can implement A's counter-proposal

[75] Since (Riker, W., 1962), the economic theory of political coalition formation focuses on the "minimal winning set" or a similar idea. Another possibility is to focus on the most complementary coalition. The most complementary coalition maximizes the gains from trading votes. See Chapter 3 of (Cooter, 2000).

under majority rule, and A's counter-proposal makes A and B better off than the initial proposal, so A's counter-proposal blocks the initial proposal. It is not hard to see that *any* proposal is blocked by another proposal. Thus A's proposal is blocked by B's counter-proposal to distribute the surplus (A,B,C)=($0,$75,$25).

When the core is empty, each player can make credible demands whose satisfaction is infeasible.[76] The contest for redistribution by majority rule destabilizes every possible coalition. Generalizing these results, Arrow proved that any democratic constitution can result in cyclical voting.[77] Voting cycles, especially provoked by a contest for redistribution, destabilize democracies, especially in developing countries.

Instead of cycling, many democracies produce stable government that pursues policies near the center of the political spectrum. Under certain conditions, voting among paired alternatives along a single dimension of choice yields an equilibrium at the point most preferred by the median voter. The median rule explains why the center dominates the politics of many democracies.[78]

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[76] Each member of a potential coalition may demand his marginal contribution to it as the price of joining. A member's marginal contribution to the coalition may be computed as the fall in the coalition's total value caused by the member quitting. Here I apply the *Shapely value* of a coalition member. See (Luce, D. and Howard Raiffa, 1967) at page 249. With *increasing returns to scale (* super-additivity), however, cooperation does not create enough value for each member to receive the marginal product of membership, so paying the marginal product of membership to everyone is *infeasible*. To illustrate concretely, consider a coalition formed by A and B that distributes the surplus equally between them: (A,B,C)=($50,$50,$0). If either member of the coalition were to leave it, the payoff to the coalition would fall from $100 to $0. By this logic, the marginal product of each of the two members of the coalition equals $100, but the total product of the coalition also equals $100. Consequently, paying $100 to each member of the coalition is infeasible. Infeasible demands may be *credible*. A threat by a member of a majority coalition is credible, according to one definition, if another coalition could satisfy the demand without worsening its own position. To illustrate by the preceding example, consider the coalition formed by A and B that distributes the surplus equally between them: (A,B,C)=($50,$50,$0). If B were to withdraw from the coalition, the coalition's payoff would fall from $100 to $0. Noting this fact, assume that B demands a payoff of $75 to remain in the coalition. The threat is credible because B could leave the coalition and form a new coalition with C, distributing the surplus (A,B,C)=($0,$75,$25), which makes B and C better off. A, however, can also make the same demand as B. So A and B can each make a credible demand for $75. Both demands cannot be satisfied, because there is only $100 to distribute. So each demand is credible and both demands are infeasible.

[77] (Arrow, K.J., 1963).

[78] The crucial condition for this result is that each voter has single-peaked preferences. With single-peaked preferences, a voter's satisfaction always increases when moving towards the voter's most preferred point along the single dimension of choice. With multiple-peaked preferences, a voter's satisfaction increases at some point when moving *away* from the voter's most preferred point. To illustrate, some voters -- call them YUPPIES -- prefer a high level of expenditure on public schools, in which case they will send their children to public school, but, if the level is not high, they would prefer it to be low so they send their

A problem of majority rule concerns intensity of sentiment. Democracy gives equal weight to all votes, regardless of how strongly the voter feels about the issues. From an efficiency perspective, however, more weight should be given to intensive preferences. To illustrate, assume that the chairman of a three-person committee asks each one to write his or her vote on a slip of paper concerning a certain proposal. When the slips of paper are collected, the chairman reports, "I have two slips marked `Yes' and one marked `No, No, oh please, please No!'" The unresponsiveness of majority rule to the intensity of feeling about issues causes its inefficiency.

Being unresponsive to intensities, the median rule is not generally efficient by the cost-benefit standard. Under a very special assumption involving symmetrical preferences, however, the median rule is cost-benefit efficient.[79]

The preceding voting and bargaining models say little about how money influences politics. Politics has a large effect on citizens, whereas each individual citizen has a small effect on politics. Since ordinary citizens gain little for themselves by participating in democracy, few citizens invest the time and energy needed to obtain detailed information about electoral candidates and issues. When citizens invest little, politicians must invest a lot to win votes. Given the ignorance of voters, politicians trade political influence for money from lobbyists. Rational actors invest in an activity, including lobbying, when the profit equals or exceeds the return on alternative forms of investment. Since laws are general, lobbying tends to affect many people and interests. Lobbyists need organize to overcome free-riding and solve the problem of collective action.

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children to private school and save on taxes. The worst alternative for the YUPPIES is a moderate level of expenditure on public schools. I review these results in (Cooter, R., 2000) Chapter 2.

[79] Majority rule counts voters, whereas cost-benefit analysis adds individual values. Counting voters gives the same result as adding individual values under the assumption of "strong symmetry." Under strong symmetry, each non-median voter who gains from a change away the median can be matched with at least one voter who loses, and the loser loses no less than the winner wins. In notation, let x_m^* denote the point most preferred by the median voter. Consider any alternative x^*. Let J denote the set of individuals who (strongly) prefer x_m^* to x^*, and let K denote the set of individuals who (weakly) prefer x^* to x_m^*. By strong symmetry, for each k in K there exists a j in J such that $u_j(x_m^*)-u_j(x^*) \geq u_k(x^*)-u_k(x_m^*)$. This fact implies

$$\sum_{i \in J \cup K} u_i(x_m^*) \geq \sum_{i \in J \cup K} u_i(x^*).$$

Splicing and Factoring

The conventional analysis of unstable democracy focuses on the relationship between the legislature and the executive. The executive provides coherence through orders. Infighting in the legislature, however, can cause paralysis or chaos. Given these facts, increasing executive power at the expense of the legislature can increase stability. The gain in stability, however, creates a risk to democracy. The executive might suspend elections and rule by decree. In the conventional analysis, the executive provides stability and potentially endangers democracy, whereas the legislature provides democracy and potentially endangers stability. Instead of the usual analysis, I view stability as depending on median democracy.

Broad jurisdiction *splices* independent issues together like the strands of a rope. By "splicing" I mean combining issues and deciding them all at once. For example, the U.S. Congress often enacts omnibus legislation with extensive log-rolling. To splice indirect democracy, citizens should elect representatives to assemblies with power over many different issues. In contrast, narrow jurisdiction *factors* politics into independent issues like a mathematician dividing a large number into prime numbers. By "factoring" I mean separating issues and deciding them one at a time. For example, citizens may elect a town council to control the police and a school board to control schools. To factor indirect democracy, citizens should elect separate governments for separate issues. To factor direct democracy, citizens should decide each issue in a separate referendum.

Sometimes a constitution factors, as when the town's constitution establishes an elected council and a separately elected school board. Alternatively, a constitution may allow for factoring without requiring it. For example, the constitutions of the U.S. states prescribe procedures for establishing special governments for such activities as parks, transportation, and water. Citizens can establish or abolish special governments by following the prescribed procedures. Alternatively, the constitution may limit or forbid factoring, as when the constitution prevents a branch from delegating authority or a government from ceding authority.

I have discussed clear-cut cases of factoring, but unclear cases often occur. To illustrate by the European Union, the ministers forming the Council of Ministers differ on

different issues. Thus the Council may consist of the national ministers of agriculture to decide a question about farm subsidies, whereas the Council may consist of the national ministers of transportation to decide a question about railroads. The national ministers of finance, however, often dictate to other national ministers. Does changing the Council's membership according to the issue in question amount to factoring the issues? As I will explain, the answer depends on transaction costs.

City Council and School Board

I have explained that splicing lowers the transaction cost of bargaining across issues, and successful bargaining across issues can increase the satisfaction of voters with complementary tastes. Splicing also increases the risk of failed bargains and circular votes. When spliced voting causes intransitivity, factored voting may improve the outcome by allowing the median voter to prevail on separate dimensions of choice. Median rule on separate dimensions of choice often satisfies the preferences of voters more efficiently than an unstable contest of distribution. Intransitive preferences in multi-dimensional choice may factor into single-peaked preferences on each single dimension of choice. In general, single-purpose government is like a safe stock with a modest yield, whereas multi-purpose government is like a risky stock that pays a lot or nothing.

To develop these points, I turn to a quantitative example. Assume that expenditure on police and schools are the two major political issues in a small town. Police and schools especially represent the two ways that government augments markets. Police are essential to secure property rights and enforceable contracts. Schools are essential to preparing people to participate in a modern, technological economy.

First consider splicing the issues of police and schools. A town council that decides both issues provides a forum for bargaining. If bargaining succeeds, council members who care intensely about police may trade votes with council members who care intensely about schools, so that each one gets what it wants most. If bargaining fails, the council members may waste resources in an unstable contest of distribution. Second consider factoring the issues. A town council that controls police and a separately elected school board that controls schools denies a forum for bargaining over the two issues.

With bargaining obstructed and assuming single-peaked preferences, the median voter prevails on each dimension of choice.

Figure 1 sharpens the example with numbers. Assume that voters in a town are divided into equal numbers of liberals, conservatives, and moderates. Expenditure can be high or low for schools and police, with the resulting net benefits for each group of voters indicated in Figure 1.[80] The liberals intensely prefer high expenditures on schools and mildly prefer the savings in taxes from low expenditures on police. The opposite is true of conservatives, who intensely prefer high expenditures on police and mildly prefer the savings in taxes from low expenditures on schools. The moderates mildly prefer the tax savings from low expenditures on police and schools. The row labeled "total" indicates the sum of net benefits to the three groups.

Figure 1: Voters' Net Benefits

	school expenditures		police expenditures	
	low	high	low	high
liberal	0	11	1	0
conservative	1	0	0	11
moderate	2	0	3	0
total	3	11	4	11

Assuming majority rule, contrast the consequences of splicing and factoring issues in Figure 1. If the issues are factored, then 2 out of 3 voters (conservatives and moderates) vote for low expenditures on schools, so factoring results in low expenditures on schools. Furthermore, 2 out of 3 voters (liberals and moderates) also vote for low expenditures on police, so factoring results in low expenditures on police. Thus factoring results in low expenditures on schools and police.

[80] I implicitly assume additively separable utility functions for each group, so any group's total utility equals the sum of its utility on each of the two issues.

If issues are spliced, the voters must choose among 4 combinations of public goods depicted in the columns of Figure 2. The net benefits to voters depicted in Figure 2 are calculated from the numbers in Figure 1. For example, (low,high) indicates low expenditure on schools and high expenditure on police, which results in a payoff of 0 for liberals, 12 for conservatives, and 2 for moderates.

Figure 2: Voter Net Benefits from Combinations of Public Goods Expenditures on Schools and Police, Respectively

	(1) (high,high)	(2) (low,low)	(3) (high,low)	(4) (low,high)
liberal	11	1	12	0
conservative	11	1	0	12
moderate	0	5	3	2
total	22	7	15	14

The numbers in Figure 2 can be used to deduce the winner in a vote between any two alternatives. If voters simply vote their preferences in Figure 2, without bargaining or trading, then an intransitive cycle results. Specifically, 2 of 3 voters (liberal and conservative) prefer (low,high) rather than (low,low). 2 of 3 voters (conservative and moderate) prefer (high,low) rather than (high,low). 2 of 3 voters (liberal and moderate) prefer (high,low) rather than (low,high). And, finally, 2 of 3 voters (conservative and moderate) prefer (low,high) rather than (high,high). As explained, column (1) beats (2), (2) beats (3), (3) beats (4), and (4) beats (1). Thus voting in Figure 2 results in an intransitive cycle.

Figure 1 and Figure 2 illustrate the general principle that splicing dimensions of choice can cause intransitivity where none exists on any single dimension of choice. Instead of simply voting their preferences, however, splicing may cause the voters to bargain with each other and cooperate. Since liberals care more about schools than police, whereas conservatives care more about police than schools, they have complementary tastes and they could profitably trade votes. A platform calling for high

expenditure on schools and police allows the liberals and conservatives to get what they want on the issue that each one cares the most about, as required for efficiency.[81] Stabilizing such an agreement requires the parties to abandon the majority rule game of distribution, which has no core,[82] and cooperate with each other.

Whether comprehensive government or single-purpose governments satisfy the preferences of political factions better depends on the ability of politicians to cooperate. In general, splicing increases the gains from cooperation and factoring issues decreases the losses from conflict. Finding the optimal number of governments requires balancing these considerations. These facts suggest the prescription, "Splice when cooperation is likely and factor when conflict is likely."

Referenda versus Legislation

Most constitutions that permit referenda restrict them to a yes-or-no vote on a single issue.[83] To illustrate, Californians might be asked to vote "yes or no" on restricting abortions and "yes or no" on capital punishment, but the law precludes Californians from being asked to vote "yes or no" on restricting-abortion-and-restricting-capital-punishment. A practical reason compels restricting each ballot initiative to a single issue. Logrolling, which combines issues in a single vote, requires bargaining. Bargaining among different groups requires representation. Ballot initiatives bypass elected representatives. Thus a multiple-purpose ballot initiative invites bargaining without any framework for it.

In legislatures the members often bargain, compromise, and draft a single bill that combines different issues. In contrast, rules restricting ballot initiatives to a single issue prevents logrolling, so different groups have little incentive to bargain or vote

[81] Cost-benefit efficiency requires choosing the level of expenditures that maximizes the sum of net benefits, which occurs with high expenditures on schools and high expenditures on police.
[82] Since the voters' preferences form an intransitive cycle, any coalition formed simply by trading votes is dominated by another coalition (empty core). For example, a liberal-conservative coalition to obtain (high,high) is dominated by a liberal-moderate coalition to obtain (high,low); a liberal-moderate coalition to obtain (high,low) is dominated by a conservative-moderate coalition to obtain (low,low); and so on. Thus the liberal-conservative coalition might not prove stable. To guarantee its stability, the parties would need the ability to make side-payments. With side-payments, the liberal-conservative coalition dominates other possible coalitions, and no possible coalition dominates the liberal-conservative coalition.
[83] See California Constitution, art. II sec. 8(d)).

strategically. When citizens vote their preferences on a single dimension of choice, the median usually prevails. In general, direct democracy factors the issues, so the median voter should prevail. In contrast, members of legislatures bargain, compromise, and roll logs. In general, indirect democracy splices issues, which should result in bargains or cycles.

The contrast between splicing and factoring predicts some consequences of a shift from indirect to direct democracy. A change from indirect to direct democracy often replaces cycles or bargains among representatives with the preference of the median voter on each dimension of choice.[84] Is this change better or worse? That depends on how well indirect democracy works. Given informed voters and competitive elections, indirect democracy produces effective representation of political interests. If representatives bargain successfully and cooperate with each other, then citizens get their way on their preferred issues. In these circumstances, indirect democracy satisfies the preferences of voters better than direct democracy.

Indirect democracy, however, can create a political cartel whose members conspire to blunt electoral competition. For example, the spectacular disclosure of corruption among leading Italian politicians in the 1990s suggests that citizens had little influence over deals struck by their representatives. An opaque political process and proportional representation made Italian electoral competition relatively ineffective. In these circumstances, a change to direct democracy can break the political cartel.

In addition, indirect democracy can cause an unstable contest of redistribution among interest groups. Changing to direct democracy can increase stability, which should increase the satisfaction of citizens with politics.

I have explained that direct democracy causes the median voter to prevail on each dimension of choice, which is better than a cycle or a political cartel, and worse than perfect bargaining by elected representatives. This proposition summarizes the main difference in theory between direct and indirect democracy. Besides this large difference, some small differences are sometimes important.

First, direct democracy gives more weight to those citizens who actually vote, whereas indirect democracy gives more weight to the number of citizens living in a district. To illustrate, assume that poor people, who vote at relatively low rates, live in poor districts. Indirect democracy apportions representatives by population, so the number of representatives from poor districts reflects the number of poor citizens, including those who do not vote. In contrast, direct democracy responds to the citizens who actually vote. Thus, in the preceding example where rich people vote at higher rates than poor people, direct democracy gives more weight to the opinions of rich people. This phenomenon may tilt California ballot initiatives in favor of older, conservative, white citizens.

Second, critics of direct democracy allege that the majority of citizens will vote to redistribute wealth from the few to the many. For example, if most citizens buy auto insurance, they will vote to cap its price. Or if most citizens rent houses, they will vote for rent control. More generally, critics of direct democracy allege that the majority of citizens will vote to undermine the rights of the minority.

This criticism, however, has a weak foundation in theory. From the viewpoint of theory, direct democracy factors voting, which does not necessarily harm minorities more than spliced voting. Spliced voting encourages citizens to coalesce into blocks in order to bargain with each other. A system of proportional representation can guarantee representation in political bargaining to every minority group. Two-party competition, however, contains no such guarantees. When groups coalesce, some minorities may suffer permanent exclusion from the ruling coalition.

In contrast, after factoring the issues, the minority on one dimension of choice is seldom the same group of people as the minority on another dimension of choice. Any single person with complicated political views wins on some dimensions of choice and loses on others. In general, factoring issues can dissolve large blocks of citizens and ensure that everyone wins some of the time. In addition, all the non-median voters

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[84] The median rules can, however, fail when voting on a single dimension of choice when preferences are not single-peaked. Furthermore, with factoring and single-peaked preferences, non-separable utility functions in multi-dimensional space can destabilize the median rule on each separate dimension of choice.

participate in determining the median voter. Thus everyone's preferences has an effect on the voter equilibrium.

Any democratic system of politics, whether direct or indirect, requires protection of minorities, such as ethnic groups and wealthy people. Forms of protection include bicameralism and constitutional rights.[85] Thus the Bill of Rights in the U.S. constitution constrains the states, so a federal judge would nullify a California referendum that violates the U.S. Bill of Rights. This fact imposes an essential constraint on California's referenda. Furthermore, on many political issues, the bicameral U.S. Congress can pre-empt states by enacting federal legislation.

Single-purpose governments and single-issue referenda increase the transaction cost of bargaining across issues. Taken to its logical limit, factoring eliminates political bargaining, which tends to eliminate vote-trading and strategic behavior. Non-strategic voting on a single dimension of choice often yields a stable equilibrium at the most preferred point of the median voter. Table 1 summarizes the difference between median and bargain democracy. Alternatively, a constitution can splice functions by creating a few broad governments, each with many purposes. In such a system, the central legislature and executive hold most power, as in France or Japan. Comprehensive government by a central legislature decreases the transaction costs of bargaining across issues. Taken to its logical conclusion, splicing results in government by an encompassing bargain. Reaching a bargain requires vote-trading and strategic behavior. Such a political system, which the second row in Table 1 summarizes, is what I call bargained democracy.

[85] (Levmore, S., 1992).

Table 1: Factoring, Splicing, and the Character of Politics

	constitutional forms	character of politics
factor	special governments, ballot initiatives	median democracy
splice	comprehensive legislature	bargain democracy

Median democracy and bargained democracy have different strengths and weaknesses, as summarized in Table 2. The median rule is stable, so referenda and single-purpose governments tend towards stability. In addition, everyone who votes contributes to determining the median, so referenda respond to voters. Besides these two strengths, median democracy has the weakness of obstructing trade across issues. Without trade, politics is inefficient relative to the preferences of citizens. In addition, referenda and single-purpose governments increase the number of elections, which can strain civic virtue. Oscar Wilde reputedly said, "The trouble with socialism is that it takes up too many evenings."[86] Similarly, referenda and single-purpose governments absorb the resources and time of many talented people.

Table 2: Median Democracy versus Bargain Democracy

	strengths	weaknesses
median democracy	responsive, stable	no trades, possibly exhausted citizens
bargain democracy	possibly efficient	possibly unresponsive, possibly unstable

86 This quote is often attributed to him, but my trusted reference librarian, Debby Kearney, could not find the sentence in his writing.

Having discussed the strengths and weaknesses of median democracy, I turn to bargained democracy. By splicing functions and reducing the number of governments, bargained democracy demands less participation by citizens in elections, which conserves civic virtue. In addition, a multi-purpose legislature facilitates bargaining. By trading across issues, politics can achieve efficiency relative to the preferences of citizens. In practice, however, political bargaining may not realize the best possibility. Indirect democracy requires citizens to monitor representatives, but each citizen has an incentive to free-ride on monitoring efforts by others. Imperfect monitoring by citizens enables their representatives to pursue objectives contrary to the interests of most voters.

Besides this agency problem, indirect democracy can provoke contests of distribution over the surplus from cooperation. A contest for redistribution wastes resources and can paralyze government. In markets, perfect competition forces everyone to trade at market prices, which solves the distribution problem. No one, however, has contrived a perfectly competitive mechanism to control the state's natural monopoly powers. As long as a democratic constitution stops short of perfect political competition, a problem of distribution will persist. Self-interested rationality does not dictate how to divide the surplus from cooperation. The resulting destabilization of political coalitions constitutes the problem of democracy's empty core.

Conclusion

This essay, which reports on the economic analysis of law and norms as it pertains to economic development, has two themes. First, business law must align with business norms, and this alignment occurs less through a political process and more through an evolutionary process that I call "market modernization." Market modernization is an evolutionary process that builds legal institutions and culture. Second, instability and corruption in developing countries results especially from insufficient democracy of the right type. The right type for developing nations plagued by instability is median democracy, which tends towards stability. Developing median democracy, in contrast, is a constitutional process. When combined, the two can protect individual rights of contract and property, and resist predation, as required for economic development.

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